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THESIS

THE FAIRNESS OF CHANGE IN THE MILITARY RETIREMENT SYSTEM

by

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December, 1995

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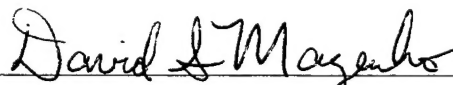
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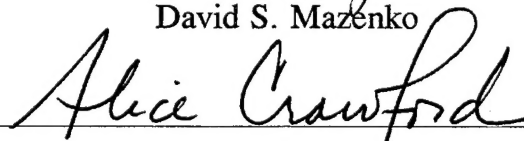
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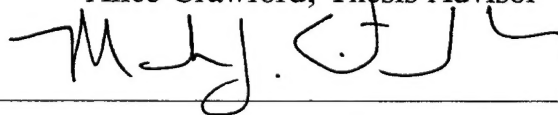


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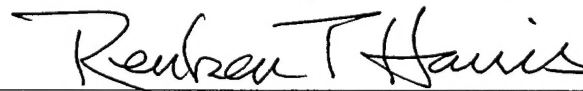
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ABSTRACT

This thesis addresses the issue of fairness as it relates to changing military retired pay. Taxpayers, as well as retirees, are seen as central to the discussion of fairness. Determination of fairness is accomplished by examining the purposes of retired pay. Further evidence of the system's fairness (or unfairness) is provided by comparisons with other retirement plans. A final perspective on fairness is obtained by analyzing how military life has changed since the current system was instituted. Each perspective suggests that military retired pay is overly generous. This thesis rejects the view that retired pay is compensation for the sacrifices endured during a military career, and concludes that the benefits provided by the current system could be reduced and still remain fair to retirees.

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I. INTRODUCTION

A. THE PROBLEM

In 1994, the military retirement system cost U.S. taxpayers \$26.8 billion. Next to Medicaid (which serves over 25 million people), the military retirement program (which benefits 1.6 million retirees) is the most expensive of all federal entitlement programs financed exclusively from general revenues. (Gansler, 1991, p. 297)

Since 1965--when any World War II veterans were eligible to retire--costs have increased nearly twenty-fold. This astronomical increase in retirement obligations and expenditures reflects the rising number of military retirees, as shown in Table 1-1.

As of 1994, the number of military retirees equaled the number of active duty service members. Beginning in 1995, the number of retirees actually exceeded the number of persons on active duty, which totaled about 1.5 million.

Unfortunately, the post-Cold War personnel drawdown will not have a significant impact on the number of future retirees. The Department of Defense (1993, p. L-8) projects the number of retirees to peak at 1.7 million in 2010, decline only slightly (to 1.64 million) by 2043, and then rise again for the remainder of the next century.

Table 1-1

Total Number of U.S. Military Retirees by Year, 1940-Present

Year	# of retirees (000's)
1940	48
1950	133
1960	255
1970	765
1980	1,265
1990	1,472
1994	1,582

Source: Department of Defense, *Statistical Report on the Military Retirement System*, 1994, p. 8.

In today's environment of constrained federal budgets, these numbers invite scrutiny of military retirement provisions. Cost-conscious members of Congress are sure to see military retirement as an opportunity for savings. As with any entitlement, military retirees are certain to feel "entitled" to the present system. Loud voices will cite *fairness* as the reason their program should not be cut. This thesis examines the issue of fairness as it relates to changing military retirement. It does not judge the merit of any specific proposal for change. Rather, it identifies and analyzes the various principles that should guide the development of any proposed change.

B. THE PEOPLE

Fairness is not a one-dimensional issue. While most discussions of military retirement have focused on the retirees, two other groups must also be considered. First, is the large number of military non-retirees. The unique structure of the military system ensures that relatively few people who enter the service will remain long enough to collect benefits. The argument could be made that retirees receive their benefits at the expense of non-retirees. For example, an editorial in *Navy Times* (November 18, 1991) states: "The unfairness of this [retirement] system generally escapes the notice of anyone other than service people who, after serving honorably for five, 10, or 15 years, leave the military with nothing but a handshake."

A more obvious group concerned with the fairness of military retirement is the taxpayers. Fairness to taxpayers dictates that they get their money's worth from any federal program. A \$26.8 billion program must be as cost-effective as possible while still accomplishing its goals. Therefore, any discussion of fairness to retirees must also consider fairness to taxpayers.

C. COMMON CRITICISMS

Numerous critics over the years have questioned the young age at which military members can retire with full benefits. Officers who retired during 1994 were 45 years old on average; at the same time, the typical enlisted retiree was less than 41. Owing to today's life expectancies, the average retiree in 1994 will receive an annuity for between 34 and 36 years. (DoD, 1994, pp. 135, 286) This long period over which inflation-adjusted benefits are received is the main reason for the high cost of military retirement.

Other criticisms of military retirement include its generous level of annual benefits; its non-contributory nature; its all-or-nothing vesting at 20 years; and the incentive it produces to leave the service shortly after becoming retirement-eligible. As Gansler (1991, p. 298) notes,

Perhaps the worst aspect of the military retirement program is that its incentives work against the armed services' manpower needs and military-readiness goals. They encourage the most skilled officers to retire just when they are reaching the peaks of their careers, rather than to continue serving the country.

None of these criticisms are new. The next section provides a brief overview of numerous studies from the past several decades that have addressed some of these issues.

D. HISTORY

In 1986, Congress implemented the Military Retirement Reform Act. Commonly known as REDUX (for reduction of benefits), the Act made several substantial changes to the manner in which retired pay is calculated. (These changes are discussed later in this chapter.)

REDUX was inspired by eight major studies of the retirement system that had been conducted over the previous 18 years. These studies include:

- 1969, First Quadrennial Review of Military Compensation (QRMC)
- 1971, Interagency Committee (IAC) on Uniformed Services Retirement and Survivor Benefits
- 1974, proposed Retirement Modernization Act (RMA)
- 1976, Defense Manpower Commission (DMC)
- 1978, President's Commission on Military Compensation (PCMC)
- 1979, proposed Uniformed Services Retirement Benefits Act (USRBA)
- 1984, President's Private Sector Survey on Cost Control (PPSSCC)
- 1984, Fifth QRMC

When compared with the specific proposals of any of these studies, the changes made by REDUX were relatively mild. In

fact, Asch and Warner (1993, p. 26) assert, "REDUX was a compromise aimed at reducing the cost of the retirement system without fundamentally altering its structure."

The fundamental structure to which they refer is that of immediate annuities after 20 years of service (YOS). A common theme in these studies is the use of a "two-tier" system, whereby annuities are substantially reduced (or eliminated) prior to old-age. With the exception of the First and Fifth QRMC, all of the studies recommended that service members be vested prior to 20 YOS (usually ten). Every study except the Fifth QRMC recommended a social security offset; that is, military retired pay would be reduced once social security benefits are received. A few more notable recommendations include:

- Members must contribute 6.5 percent of pay. (First QRMC)
- Two percent reduction for each year under age 60. (IAC)
- Require 30 YOS to retire for non-combat arms. (DMC)
- Annuities begin at age 60, with lump sum of two years pay at separation. (PCMC)
- Annuities begin at age 55, with decreasing transition payments for five years after retirement. (PPSSCC)

This brief discussion illustrates that concern over military retirement pay is not a new issue aimed at the

current budget crisis. Rather, each time the system is studied in detail, it is found to be inappropriate in numerous areas. This holds true whether the study is appointed by the Executive Branch, Congress, or the Department of Defense (DoD). Several major reforms actually became legislative proposals, only to fade and die in Congress. Since the passage of REDUX in 1986, no major proposals have emerged. However, new reforms will undoubtedly be suggested in the future. Some might argue that another change should not follow too closely on the heels of REDUX. But REDUX did not implement changes of the nature and magnitude recommended by eight previous studies; therefore, it provides a rather weak shield against future changes.

E. THE CURRENT SYSTEM

Due to changes made to the military retirement system in 1980 and 1986, three systems are actually operating at the present time. First of all, people who entered the military prior to September 8, 1980 receive retired pay at the rate of 2.5 percent of final basic pay for each year of service. This formula equates to the well-known 50 percent of basic pay at 20 years, and 75 percent at 30 years. Benefits are fully adjusted for inflation each year.

In September 1980, the "High-3" system became law. It is identical to the previous system except that calculations are made on an individual's high three years' average basic pay rather than final basic pay. The 1980 change obviously did not constitute an overhaul of the retirement system. It was simply a moderate cost-cutting measure, applicable only to retirees who entered the military after its implementation. As such, savings would not be realized for another 20 years.

As mentioned previously, REDUX implemented several substantial changes that became effective August 1, 1986. Realizing that the previous systems provide tremendous incentive to retire shortly after serving 20 years, REDUX calculates retired pay as two percent (as opposed to 2.5) of basic pay for each year of service up to 20. Retired pay is then increased by 3.5 percent (instead of 2.5) for each year over 20. Thus, REDUX provides a significant incentive to serve past 20 years, as a 20-year retiree receives 40 percent of high-3 basic pay, while a 30-year retiree still receives 75 percent. Under REDUX, annual adjustments for inflation are reduced to one percent below the growth in the Consumer Price Index (CPI). At age 62, benefits are restored to the level they would have been with full indexing; thereafter, adjustments revert to the CPI minus one percent rule. Table 1-2 juxtaposes the three systems.

Table 1-2

Annual Retired Pay Under the Three Current Military
Retirement Systems, 1992

Grade/YOS	Pre-1980	High-3	REDUX
O-4/20	\$22,435	\$20,852	\$16,681
O-5/22	\$28,518	\$26,965	\$23,043
O-6/26	\$39,417	\$37,542	\$35,232
O-7/30	\$56,144	\$53,536	\$53,536
E-7/20	\$12,029	\$11,320	\$9,056
E-8/25	\$18,227	\$17,105	\$15,737
E-9/30	\$27,294	\$26,110	\$26,110

Source: Asch and Warner, 1994, p. 46.

Both High-3 and REDUX achieved cost savings over the system they replaced. REDUX was more comprehensive in that it also addressed a manpower problem. Furthermore, it acknowledged the appropriateness of a two-tier system that distinguishes between a retiree's second-career and old-age phases.

Future proposals to change the retirement system cannot be too narrowly focused if the change is to be meaningful and lasting. The High-3 change of 1980 was concerned primarily with saving a few dollars without angering anybody. To this extent, it was successful, but the narrow focus invited an even bigger change just six years later.

In light of the criticisms presented earlier in this chapter, calls to modify REDUX will undoubtedly be heard in the future. The success of any new change will depend upon how well reformers address important aspects of the retirement system: specifically, its costs, the needs of the Services, and fairness to all concerned. The best way to frame any such proposal is to determine what the retirement system intends to accomplish.

II. PURPOSE OF THE MILITARY RETIREMENT SYSTEM

Meaningful discussion of military retirement reform cannot begin without a thorough understanding of the system's purpose. This basic premise is not contentious, but the ferocity of reaction from retirees when confronted with a relatively minor proposed change indicates that the purpose of retirement pay may be grossly misunderstood. A plethora of recent letters to *Navy Times*, for example, suggests that many military members view retired pay as a reward for the hardships they endured during a career of long and faithful service.

This problem of perspective is not confined to the current debate over retirement. Cooper (1977, p. 375) laments that "discussions about the problems have tended to focus on retirement for retirement's sake, rather than upon the role that retirement ought to assume, first, relative to other components of the compensation package, and second, in the larger context of force management."

Cooper's notion is supported by the explicit statements from various government commissions that have reviewed the retirement system during the past several decades. They consistently indicate that the idea of a reward for long service has little bearing on retirement pay. The theme of force management as the primary purpose of the retirement

system appears repeatedly. Additionally, economic theory helps explain why retired pay is structured uniquely in the military, and why the current arrangement is not necessarily the best one. Thus, economic theory also supports the notion that the primary purpose of retired pay is simply to help shape the force.

A. GOVERNMENT STUDIES

Both government and private studies of military retirement attempt to define the purpose of the system before engaging in their analytical work. That is, of course, as it should be; yet, enormous confusion would result if each study formulated its own purpose for the system. Fortunately, most research tends to draw upon a small handful of prominent government studies. Foremost among these reports are the 1948 *Career Compensation for the Uniformed Services* (or the Hook Commission Report), the *Fifth Quadrennial Review of Military Compensation* (QRMC), and the *Seventh QRMC*.

1. The Hook Commission

The end of World War II necessitated a major review of military compensation. This comprehensive study--which resulted in the Hook Commission Report--did not mince words when discussing the purpose of the retirement system:

...a sound retirement system is essential to solving the superannuation problem. The services must be kept young, vigorous, and efficient; a sound retirement plan with a proper compulsory retirement age will permit youth and brains to rise to the top in time to be effective...This vitalization purpose is not new; it was the fundamental premise of the present retirement system when it was established 80 years ago. Other concepts of fair treatment and the traditional concepts of retirement for those taking up the profession of arms are also important and have been given consideration but the Commission does not consider them to be controlling. (Asch and Warner, 1994, p. 22)

Even with the recent completion of a war that caused untold grief and hardship for millions of Americans, the Commission specifically addressed the fairness issue and relegated it to secondary importance.

2. The Fifth QRM C

The Fifth QRM C (1984) was charged with examining the retirement system, and it subsequently proposed substantial changes that became law in 1986. Its stated purpose for the retirement system was "to support and complement the manpower force management requirements of the Services in order to meet national security objectives." (Fifth QRM C, 1984, p. I-1) However, the Fifth QRM C expanded on this basic purpose. It reiterated the "youth and vigor" requirement set forth by the Hook Commission, and added the following purposes of the retirement system:

- Recognize the arduous nature of military service
- Maintain a mobilization base
- Provide for financial security in old age
- Encourage maximum career length consistent with needs
- Be fair to the service member and taxpayer
- Allow service member to plan for the future
- Provide for the equitable treatment of all retirees

These purposes are both illuminating and confusing. Clearly, the Fifth QRMC is sensitive to the individual. Although force management is still stated as the system's foremost goal, fairness and equity are also given explicit consideration. But interpretation of these considerations is difficult. For example, "equitable treatment" is not defined at all. Under "planning for the future," the Review states that the purchasing power of retirement pay should be protected against inflation. However, the Fifth QRMC itself recommended a reduced annual cost-of-living adjustment (COLA) for retirees, which later became law. So, the Review should have clarified what it intended with some of its secondary purposes. Additional problems with the interpretation of these broad statements are discussed below.

3. Seventh QRMC

The Seventh QRMC (1992) did not focus primarily on retirement. However, it did take the principles of compensation outlined by the Fifth QRMC and further expand upon them. Unfortunately, this expansion does not serve to clarify the ambiguous purposes outlined by the Fifth QRMC. For example, the Seventh QRMC notes that officially recognized principles could be used by Congress and the Department of Defense to support or defend proposed changes. Herein lies the problem: the lengthy set of principles presented by the Seventh QRMC are so broad as to allow either *support* or *rejection* of the same proposed change! For instance, the Seventh QRMC states that pay should be no higher than needed to achieve recruiting and retention goals. This would support the proposal of calculating retired pay on the average of the last year's pay (High-1) rather than on pay at the date of retirement (provided retention would not suffer). But on the very next page, the Review (1992, GSP-F, p. 3) states that the pay system "generally must provide the lifetime remuneration promised at the outset of a member's career." This principle clearly supports retaining the *status quo*.

B. ECONOMIC THEORY

1. Internal Labor Market

The military's unique needs dictate that nearly all hiring be done at the entry level. Thus, an *internal labor market* exists, whereby all promotions occur from within the organization--lateral entry is rare. This lack of lateral entry constitutes a major difference between the military and civilian firms with regard to retirement systems. The civilian firms generally are not as concerned with maintaining "youth and vigor," thus lessening the need to generate turnover among older employees. (Asch and Warner, 1994, p. 20)

Does the military's retirement system effectively generate turnover among older "employees" to maintain the youth of the force? Asch and Warner (1994, p. 16) calculate that the average time served after becoming eligible for retirement is only one year for enlisted members and about four years for officers. In fact, the incentive to leave once vested is so strong the retirement formula was changed in 1986 to encourage retention beyond twenty years. Service members typically look at serving past twenty years as "working for half-pay." (Congressional Budget Office, 1984, p. 18)

The 1986 change does not address a more fundamental question. If the lure of retirement pay is so strong that almost no voluntary separation occurs between the tenth and

twentieth year of service (Asch and Warner, 1994, p. 9), does this logically imply that the level of retired pay could be reduced without raising mid-career separations to an unacceptable level? The answer should be "yes," since everybody with ten through nineteen years of service is obviously not operating "on the margin" with respect to a quitting decision.

Entrants to the military in 1986 are not quite halfway to their retirement eligibility point, so their retention behavior from ten through nineteen years of service is yet to be seen. But, if their behavior remains similar to that of current mid-careerists, little justification would remain for not changing the retirement system further. Even after examining various equity issues surrounding the military retirement system, the Congressional Budget Office (1984, p. 18) concluded that "retention of the current system is not justified if manpower goals could be adequately met under a less costly system." (The applicability of this statement is not confined to the 1984 debate. The fundamental principle is timeless.)

2. Consequences of the Current System

The attractiveness of military retirement pay produces a force structure containing too many mid-careerists. (Asch and Warner, 1993, p. 3) Numerous studies have addressed the

"implicit contract" that the retirement system makes with mid-careerists. The services are understandably reluctant to separate mid-careerists due to the large financial impact that the loss of retirement benefits would cause. Table 2-1 reveals the lack of a "pyramid" length-of-service distribution often associated with the military. Rather, the strong pull of retirement, coupled with reluctance to separate members involuntarily, is evidenced by the nearly constant percentages from years twelve through twenty.

3. Deferred Compensation

Military retirement pay is often thought of as *deferred compensation*. But serious misunderstanding of this important economic concept often results. Flanagan et al. (1984, p. 280) explains that time-based systems of compensation are instituted by the firm to motivate hard work over a long period of time. The effectiveness of deferred compensation lies in the fact that rewards are given only after diligent effort has been expended by the worker, who has been observed by the employer for a long time. Pensions, then, represent the equivalent of a deferred payment at the end of a career. Flanagan et al. (1984, p. 284) further state: "The strongest incentives for diligence under a pension scheme would exist if the pension were not vested."

Table 2-1

Percentage Distribution of Active Duty Military Personnel by
Length-of-Service Increment, 1993

Length of Service (Years)	Percent
0-2	20.6
2-4	17.0
4-6	11.3
6-8	9.3
8-10	7.8
10-12	6.5
12-14	6.1
14-16	5.9
16-18	5.6
18-20	5.0
20-22	2.3
22-24	1.2
Over 24	1.3
All Years	100.0

Source: Adapted from Department of Defense, *Valuation of the Military Retirement System*, 1993, p. C-9.

The military retirement system is a classic example of using deferred payments to motivate hard work throughout a career. Combined with "up-or-out" policies, the retirement system ensures that military members who survive to retirement have been very productive over the years. This process also ensures some degree of *self-sorting*, whereby only people who believe they have the skills and abilities to survive for a whole career will decide to stay early on, while the others will leave. (Asch and Warner, 1994, p. 21)

So, the military uses its retirement system as deferred compensation to induce desired behavior from service members throughout their careers, just as economic theory dictates. Confusion arises when service members view retirement pay as compensation for the rigors endured during a military career. Asch and Warner (1994, p. 30) quote the First QPMC on this subject:

The argument that an additional increment should be included in the retirement annuity for the extra hazards, rigors, and inconveniences of military service was rejected on the grounds that inclusion of such an increment would be:

- inequitable, because only those military members who stayed until retirement would receive it...

Common sense plainly reveals that the rigors mentioned are endured by *all* service members, not just those who retire. In fact, millions of service members, including those who have fought in wars, have left the military before retirement; at

the same time, many retirees may have actually endured fewer rigors than non-retirees. So, retirement pay cannot be a reward for these rigors; otherwise, as pointed out by the First QRMC, the system would be grossly unfair to non-retirees. The complete misunderstanding of the economic concept of deferred compensation is what leads many officers to defend the current system with uninformed and overly emotional letters to media outlets such as *Navy Times*. (Oct. 2, 1995, p. 34 provides several examples)

Clearly, military retirement pay encourages people to leave the service after 20 years. It also encourages departure early in a career for service members who doubt their ability to remain for 20 years. After extensive research on the retirement system, Asch and Warner (1993, p. 18) conclude: "So if there is a distinctive (if not unique) purpose for military retired pay, inducing **voluntary** separations at the appropriate points...must be it."

C. SUMMARY OF PURPOSE

This discussion about the purpose of the retirement system is necessary before considering any proposed changes. Changes that conflict with the primary purpose of the system should be challenged, and changes that support the purpose of the system should be given serious consideration, especially

if the change offers savings to the taxpayer. This process of considering the "good" and challenging the "bad" would be strengthened with a more succinct set of guiding principles and purposes for the retirement system. The Seventh QRMC's list is far too broad and ambiguous. Despite the prevailing climate of political correctness, little benefit is derived from explicitly stating equity as a goal of the system. Equity should be a desirable by-product of any policy; no properly designed policy should ever be instituted with the goal of creating inequity.

Government studies of military retirement consistently state that force management is the primary purpose of the system. Economic theory helps explain why this is so. Meaningful discussion of military retirement reform must consider this primary purpose first; secondary purposes should be given lesser consideration.

III. COMPARISONS

Determining the purpose of the military retirement system still does not disclose what the actual levels of retired pay should be. Insight into that question is often obtained through comparisons with other systems, most notably foreign military retirement systems and U.S. private pension plans. (Distinctions need not be made with Civil Service plans, since they can be viewed as comparable to those in the private sector.) (Fifth QRMC, 1984, p. I-7)

The first comprehensive study to compare the U.S. military retirement system with that of foreign countries was done by the Third QRMC in 1976. In 1983, the General Accounting Office (GAO) and the National Defense University separately undertook similar studies; and in 1992 the Seventh QRMC included a Global Subject Paper on foreign comparisons. An extensive review of military and private retirement systems was made by the President's Private Sector Study on Cost Control (PPSSCC) in 1984. Simply making comparisons between systems is a fairly straightforward task. The difficulty lies in judging whether the comparison provides enough quality information upon which to base a change to our own system.

A. USEFULNESS OF COMPARISONS

Though comparisons with other systems seem very reasonable, the approach is fraught with complications. A truly valid comparison would have to be made with all other factors remaining constant, which is obviously impractical. Even though the comparisons are made with other "developed" countries, the differences among them are enormous. Some of the differences that make retirement comparisons difficult include:

- Societal values
- Political form
- Alternative employment opportunities
- Integration with other state programs
- Mobilization status of retirees

Most studies that undertake a comparison with foreign systems acknowledge this difficulty. For example, the Fifth QRM (1984, p. VII-29) states: "The complexity of the different retirement systems...soon turn specific comparisons into an exercise of mental gymnastics." Similarly, the Seventh QRM (1992, GSP-A, p. 1) admits that "wide differences...made it difficult to draw definitive conclusions."

Nevertheless, these difficulties do not completely invalidate the comparisons. Although there are obvious problems in comparing specific features from specific countries, overall trends and concepts can be obtained that are useful in examining the U.S. system.

Similarly, the comparison with U.S. private plans can provide insight, even though military service is substantially different than typical civilian employment. As discussed in Chapter II, the purpose of each retirement system may also differ markedly. Despite the "superficial resemblance" between the military and civilian plans, the Military Compensation Background Papers (1991, p. 447) note that military retirees are subject to recall to active duty, and they remain fully subject to the Uniform Code of Military Justice. These differences, then, could serve to justify some disparity between the systems. But if the standard of "comparable to the best" private sector plan (PPSSCC, 1984, p. III-281) is accepted, then the differences should not be too large.

B. VARIOUS PLANS

1. Foreign Military Plans

The nations most often chosen for comparison with the U.S. are Australia, Canada, Great Britain, France, and

Germany. Highlights from the GAO study (as reported in the Fifth QRM, 1984, p. VII-29) include the following general observations about foreign military retirees:

- Retirement age is higher than for U.S. counterparts.
- Members must contribute to the plan and/or have their military pension reduced under national social security plan.
- Vesting is accomplished prior to 20 years.
- Cost-of-living adjustments are either partial or delayed until age 55.
- Reserve retirement does not exist.

The Fifth QRM (1984, p. VII-29) concludes that, with the exception of the Australian system, "the early [20-year] retirement provisions are not as attractive as the U.S. system and do not encourage many early retirements." The Congressional Budget Office (1984, p. 31) voices a similar conclusion: "In most cases other countries' military retirement plans are considerably less generous than the current American military retirement system, especially for 20-year retirees."

2. U.S. Private Plans

The General Accounting Office used the results of five private-sector surveys to compile a short list of features

common to non-federal retirement programs. (GAO/OCG-84-2, 1984, p. ii) These common features include:

- Vesting is accomplished after ten years.
- Benefits are integrated with social security.
- Five-year average salary is used to compute benefits.
- Employee contributions are not required.
- Full benefits are not available until age 62.
- Reduced benefits are available at age 55.
- COLAs average just 38 percent of inflation.

Clearly, military retirement is more lucrative on most points. When total lifetime retirement earnings are calculated, the generosity of the military system is readily apparent. Binkin and Kyriakopoulos (1981, p. 63) calculated that lifetime retirement pay (for a typical enlisted person) is 16 times greater than that from a typical private firm, and nearly three times better than retirement from a hazardous occupation such as law enforcement or fire fighting. The PPSSCC (1984, p. III-286) made more rigorous calculations and determined that the benefit level of the service plan is six times as great as the best private sector plans. The Fifth QRMC (1984, p. VII-35) made additional calculations to correct for demographic and economic assumptions, but still concluded

that the military retirement system is at least twice as costly as a comparable private plan would be.

C. INSIGHTS

This chapter attempts to capture the spirit of many in-depth studies of the military retirement system compared with other plans. The consistent and unambiguous conclusion is that the U.S. military retirement system is more generous than those of most foreign nations (the only possible exception is Australia), and much more generous than U.S. private plans. This conclusion is important because it helps shape the notion of what is fair. Ultimately, the concept of fairness has meaning only relative to other people. A completely objective notion of fairness cannot exist, which is why comparisons are made in the first place. The comparisons, then, provide one important criterion for judging questions of fairness. When combined with other criteria from the next chapter, a background can be established for meaningful evaluation of the fairness of proposed changes to the retirement system.

IV. THE ISSUE OF FAIRNESS

Any attempt to determine the fairness of a change to the retirement system is problematic. "Fair" means different things to different people; and, as various studies have mentioned, the retirement system must be fair to the service member as well as the taxpayer. Therefore, a working definition must be established to guide judgment on the issue. Webster's New Collegiate Dictionary (1976, p. 411) provides a starting point by distinguishing between the concepts of *fair*, *just*, *equitable*, *impartial*, *unbiased*, *dispassionate*, and *objective*. All of these concepts share the element of "free from favor toward either or any side." The individual definitions stress that a fair judgment must be free from emotional involvement. Therein lies the problem--the retirement system evokes tremendous emotion from people who have spent 20 to 30 years in uniform. So, a notion of fairness is needed that is more rigorous than a simple definition. That notion is provided in the next section, followed by various other ideas that are central to the issue of fairness: *implicit contracts*, *implicit promises*, and *budget considerations*.

A. EQUITY THEORY

In 1965, organizational psychologist J.S. Adams developed an "Equity Theory" to explain how individuals evaluate the fairness of their treatment within an organization. (Organ, 1988, p. 69) The theory states that people obtain the ratio of their "outcomes" to their "inputs," and then compare the ratio to that of another comparable person. Outcomes are anything of value derived from the organization: pay, prestige, awards, retirement benefits, etc. Inputs are anything the individual brings to the organization: ability, effort, seniority, education, etc. Fairness is perceived when a person's Outcome/Input ratio is equal to that of the comparable person.

Equity theory, then, can help determine what is perceived as fair by service members with regard to changes in retirement pay. The important question becomes one of determining just *who* the "comparable person" should be. Chapter III offered two such persons--a foreign military counterpart and a typical American worker. In each case, one aspect of outcomes (retirement pay) was found to be greater for the U.S. service member. But the idea of a service member comparing his or her Outcome/Input ratio to that of a foreign military person is not very plausible. In fact, the service member probably does not even contrast the ratio to that of a

comparable civilian. Organ (1988, p. 74) cites research that found an "overwhelming tendency" for people to make comparisons with others from within the *same* organization. He states:

Perceived unfairness resonates more shrilly as it strikes at lower levels, most notably in the group in which we interact, somewhat less so in comparisons with contiguous groups or units.

Thus, equity theory has implications for the retirement system. If pay is changed such that the Outcome/Input ratio is lower (due to a smaller numerator), perceived unfairness is not likely to be overwhelming, provided the change applies to everyone *within* the organization. Another important factor is what Organ (1988, p. 74) refers to as "the temporal dimension of fairness." He states: "What might otherwise seem criminally unjust in the short run might be absorbed without a whimper in a longer framework." Any concerns about the perceived unfairness of a change must consider this temporal dimension. Although emotions are intense during any debate on retired pay, a change would not likely produce the "chronic, action-arousing sense of injustice" that Organ (1988, p. 65) says is necessary before an "unfair" situation leads to a decision to leave the organization.

B. IMPLICIT CONTRACTS

A unique feature of the military retirement system is its "cliff-vesting" provision. That is, members who separate prior to 20 years of service (YOS) are not entitled to any retirement benefits, while those with at least 20 YOS are fully vested. Many service members believe that this cliff-vesting feature has created an "implicit contract" with DoD. Under this implicit contract,

...military personnel have come to expect that once they have gained six or eight years of tenure, they will be virtually guaranteed the opportunity to serve for twenty years and qualify for a retirement annuity. (Mehay and Hogan, 1995, p. 3)

Although the lack of an explicit legal contract could be cited to absolve DoD from the obligation of retaining mid-career personnel, the traditions of the services have generally validated the notion of an implicit contract. For instance, the Army's Qualitative Management Program (QMP) was established to involuntarily separate the lowest performers in grades E-5 through E-9 each year. But the QMP board selects only those who have already served at least 20 years. (Asch and Warner, 1993, p. 22)

An extremely vivid acknowledgement of the implicit contract with mid-careerists is DoD's use of separation incentives to accomplish its force downsizing goals from 1992 through 1995. As Mehay and Hogan (1995, p. 4) note:

Using reductions-in-force (RIF's) would have broken the implicit long-term contract with career personnel, imposing significant losses of pension wealth....The potential loss of reputation as an employer for the Defense Department may have created future recruiting and retention problems.

To avoid these problems, the Department of Defense introduced a separation bonus to induce selected careerists to resign voluntarily prior to becoming retirement-eligible.

Thus, DoD spent hundreds of millions of dollars to honor the implicit contract, even though the need for a dramatically smaller force was already recognized and accepted.

C. IMPLICIT PROMISES

The point of the foregoing discussion is to distinguish between the implicit contract made to mid-careerists, and implicit promises so often mentioned in the debate over retirement. Although often used interchangeably in the literature, this paper distinguishes between the terms *implicit contract* and *implicit promise*. The implicit contract described above is well-established, while the notion of an implicit promise appears to be a tool of expedience, invoked by those wishing to retain the *status quo*.

In the ongoing debate over COLAs, the president of The Retired Officers Association (TROA) cites "the longstanding verbal and written COLA promises the government made to generations of members in uniform." (Maze, April 10, 1995, p.

6) The nature of these promises is unclear, but TROA's assertion is not completely without merit. As mentioned in Chapter II, the Fifth QRMC states that the purchasing power of retired pay should be protected against inflation. This obviously is not intended to mean full protection, however, since the Fifth QRMC recommended a reduced COLA.

The Seventh QRMC (1992, GSP-F, p. 11) adds fuel to the notion of implicit promises by stating that any *significant* compensation policy change should apply only to new entrants. The implication is that no major change to the retirement system should affect anyone already on active duty. Thus, the concept of *grandfathering*--or exempting persons already subject to the old system-- is seen as central to the issue of fairness. Indeed, most major studies of retirement reform since 1969 have recommended grandfathering all or most active duty personnel. (Congressional Budget Office, 1984, p. xvi)

Nevertheless, the great care taken to protect persons already on active duty seems somewhat unreasonable. Numerous studies have found that retirement benefits begin to influence the retention decision no earlier than the sixth to eighth year of service. (Binkin and Kyriakopoulos, 1981, p. 70) Therefore, a grandfathering provision that extends back just 12 to 14 years (versus 20) is not likely to have much of an effect on retention. When considering raising the retirement age for social security, the President's Commission on Pension

Policy (1980, p. 47) recognized that a "social contract" exists with people who are approaching retirement age--not with everyone already in the workforce.

Accepting the idea that *major* changes to the retirement system should be partially grandfathered certainly does not imply that a similar implicit promise extends to any proposed change. In fact, the Concord Coalition rejects the idea that implicit promises of COLAs exist at all. The Coalition asserts: "The public is not necessarily wed to a 'deal' that promises they will collect whatever they're 'entitled to' under current law--no matter what the consequences." (Adde, September 18, 1995, p. 22)

Finally, if implicit promises actually do exist, then the government would have no obligation to include any active duty service members in a proposed change that works to the member's advantage. One can only imagine the uproar if the government proposed to restore full COLAs to post-1986 retirees, but excluded everyone already in the service on the grounds that a promise of reduced COLAs was agreed to at the time of the person's entry into the military.

This discussion concludes by reiterating the distinction between implicit contracts and promises. DoD's implicit contract exists with mid-careerists and indicates that service members in good standing will not normally be involuntarily separated after about 12 YOS. The actions of the services

over the years have validated this concept. Implicit promises, on the other hand, are vague notions that the retirement provisions in effect at the time of joining the military cannot be changed during an entire career. The cry of "implicit promise" typically arises when no other compelling argument is available.

D. BUDGET CONSIDERATIONS

The need for military retirement reform has been highlighted by the nation's \$5 trillion debt. But even if no annual budget deficit existed, changes to the system would be warranted simply because "the services must establish pay rates that are no higher than needed to achieve recruiting and retention goals." (Seventh QRMC, 1992, GSP-F, p. 10) Chapter II shows that the current system is too successful at retaining mid-careerists. As Asch and Warner (1994, p. 26) observe, "the basic criticism of the 20-year system regards the force structure that it produces."

When the generous foundations of the current system were established after the Civil War, the Republican platform proclaimed that "in the presence of an overflowing treasury, it would be a public scandal to do less for those whose valorous service preserved the government." (Will, 1995, p. 9A) The idea of generosity during abundant times is

appealing. But today, the federal treasury is hardly overflowing. The nature of the "public scandal" may have reversed.

Like all special interest groups in our democratic system, the military retirement lobby exerts influence in the budget process, yet remains largely unchallenged by other groups. Binkin and Kyriakopoulos (1981, p. 66) offer the following observation:

The constituency favoring retirement reform is neither widespread nor well organized. The military establishment opposes reform of compensation in general and of retirement in particular. While the typical taxpayer may feel that benefits are overly generous, the feelings apparently do not run deep enough to foster active citizen involvement.

But today, as various federal programs compete for fewer dollars, supporters of the military system may be required to offer a stronger justification for its provisions. Justification often centers on the "X-factor," or the conditions of employment in military service that differ from those in civilian occupations. The next chapter provides a closer look at the so-called X-factor.

V. THE CHANGING NATURE OF MILITARY LIFE

The Seventh QRM (1992, p. 4) states: "It is reasonable to ask whether a compensation system that matured in the middle of the twentieth century for a largely conscripted force will remain viable into the twenty-first." Conscription has not played a central role in the shaping of the retirement system, since the career force has always been voluntary. Nevertheless, the question of whether the old system is appropriate for the future must still be asked. The basic structure of the current retirement system--with immediate annuities after 20 YOS--has been around since the end of the Civil War. Since that time, society has undergone tremendous cultural, economic, and technological changes. Accordingly, the military of today is immensely different from that of Civil War times.

The next three sections examine areas of military service that have changed dramatically over the past 130 years. The investigation of *the X-factor*, *second careers*, and *the evolution of warfare* can provide useful insight into the question of whether or not changes to the current retirement system may be fair to service members.

A. THE X-FACTOR

1. Negative Aspects

The X-factor includes aspects of military service that are substantially different from civilian employment. Discussion of the X-factor focuses almost exclusively on its negative side and includes elements such as:

- Military discipline
- Family separations
- Field duty
- Frequent moves
- Possibility of combat

Without a doubt, the X-factor heavily influences a person's decision to join the military and, subsequently, whether to remain in service past an initial obligation. The relevant question is whether the X-factor *can* or *should* be specifically addressed in the compensation system, and particularly in the retirement system.

Harris (1994, p. 12) states that "the X-factor is an integral element in determining military compensation." But the United States has never included any payments specifically for the X-factor. The X-factor, then, does not determine pay in any direct way. As the Congressional Budget Office (1984,

p. 15) notes, "it [X-factor] merely explains some of the difficulties of meeting military manpower requirements." In other words, if an adequate number of recruits join the service at a certain level of pay and benefits, one may assume that the negative side of the X-factor has been somehow offset. The attractions of military service have indirectly compensated for the X-factor by virtue of the fact that sufficient numbers of qualified people are willing to join.

Consideration of the X-factor becomes even less meaningful when discussed in relation to retired pay. As mentioned in Chapter II, withholding payment for the X-factor during active-duty, and then providing it during retirement would defy common sense. As indicated by Table 5-1, only one out of three officers, and one out of eight enlisted members, remain on active duty until becoming retirement-eligible.

Compensating *only* retirees for the X-factor would be quite callous to the vast majority who do not retire, especially the ones who have fought the nation's battles. But when viewed properly as a force management tool, retired pay *should* be given only to those whose retention behavior suits the services.

The idea that the X-factor should not be considered when discussing the retirement system is very difficult for many service members to accept. In arguing against proposals to reduce retiree COLAs, The Retired Officers Association

Table 5-1

Expected Percentage of Military Entrants Remaining Until Retirement, by Officer/Enlisted Status and Service, 1990

Service	Officers	Enlisted
Army	35	10
Navy	25	13
Marine Corps	25	10
Air Force	40	16
DoD Average	31	12

Source: Asch and Warner, 1994, pp. 11, 16.

president states: "These proposals completely ignore the extensive sacrifices inherent in a 20- to 30-year military career...." (Maze, 1995, p. 6) But the extensive sacrifices (the X-factor) had already been compensated for *during* the career, as evidenced by the retention behavior. (Of course, retention behavior is often driven by the "pull" of retirement benefits.) The criterion of fairness--that it be free from emotional involvement--is nowhere clearer than in this debate over retired pay. Only when service members can free themselves from the "X-factor trap" can they accurately evaluate the fairness of the retirement system.

Finally, if the X-factor is contemplated, then it might be considered in its historical context. The "dis-amenities"

of serving today are certainly much less severe than existed 100, 50, or even 20 years ago. Family separations are mitigated somewhat by fast mail service and modern telecommunications. Current concerns for housing, day care, spousal employment, family health care, and so on have resulted in a continuing focus on "quality of life" by the nation's military and political leaders. A majority of service members now live off-base. In short, military service is seen by some as becoming more of an "occupation" and less of an "institution." (Faris, 1995, p. 411)

2. Positive Aspects

As noted, the X-factor is normally viewed as encompassing the hardships of military service. Clearly, though, military service also contains positive aspects that distinguish it from civilian employment. A partial list of these "psychic benefits" includes:

- Service to country
- Pride in the uniform
- Sense of self-worth
- Development of leadership skills
- Variety of jobs
- World-wide experiences

Among those who join the service, the anticipated positive aspects of military life must appear to counterbalance the anticipated negative aspects. Of course, many people misjudge their "taste" for military life and are either discharged prematurely or leave after their initial obligation. But military members who reenlist, again and again until becoming retirement-eligible, have obviously demonstrated a very strong taste for service life. For them, the psychic benefits of serving are enough to offset the negative X-factor. The voluntary nature of service makes it so. If service members were *drafted* for an entire career, compensation for the X-factor would be justified in the form of retired pay. But retirees remained in service precisely because they had a strong taste for military life (relative to those who got out); so, any additional compensation for the X-factor during retirement would be gratuitous. The retirement system needs to provide enough incentive for the services to meet their personnel retention goals and provide a "socially acceptable" level of pay during old-age. (MCBP, 1991 p. 447) Anything above that amount may constitute an unfair burden to the taxpayer.

B. SECOND CAREERS

As the military becomes more technological, more skills acquired by its members are transferrable to the civilian labor market. A nineteenth or early twentieth century retiree likely acquired few marketable skills while in the service. Today, however, the overwhelming majority of military members do not serve in combat arms occupations. Also, owing to an increased level of health and life expectancy, today's young military retirees are better equipped to enter a second career than were their predecessors.

Numerous studies have found a second career income loss for military retirees. That is, the retirees generally tend to earn less than their comparably aged and educated civilian counterparts. Part of this difference is undoubtedly attributable to a voluntary decision to work less (more leisure) for some military retirees. But these same studies found that *total* second-career income (including military retired pay) *exceeds* the income of the civilian counterparts. (CBO, 1984, p. 16) Therefore, some reformers have suggested that retired pay during the second-career phase (prior to age 62) should be set at a level that just compensates for the second career earnings loss. (Asch and Warner, 1994, p. 31)

In short, productive second careers for young military retirees have become commonplace in recent years, and this

will certainly continue in the future. A military retirement system that was designed and implemented when second careers were impractical is probably not the fairest system under these dramatically changed conditions. As retired Army General William Dupuy states, "the idea of 40-year-old people 'retiring' is repugnant to the taxpayer and incompatible with the American work ethic." (Binkin and Kyriakopoulos, 1981, p. 71) Of course, General Dupuy realizes that military retirees do not "retire" in the strict sense. In the interest of fairness, the time has come for the retirement system to reflect the dual-career nature of modern military retirees.

C. THE EVOLUTION OF WARFARE

Of the many individual factors that collectively constitute the X-factor, perhaps none is more significant than the obligation to participate in war. Even if a service member never actually engages in combat, the *possibility* of war is always present during a military career. Therefore, an issue that can produce some insight into the nature of military life is whether the dangers of war have been increasing or diminishing over time. A related issue is whether the likelihood of serving during a war is growing or declining.

1. Less Deadly

Despite enormous increases in the lethality of modern weapons, modern wars fail to produce higher casualty rates than more "primitive" wars. The reason is surprisingly simple: modern tactics have adapted to the weapons, resulting in an extremely high degree of dispersion on the battlefield. Dupuy (1980, p. 310) calculates that while the lethality of modern military formations has increased by a factor of 2000, dispersion has increased by a factor of 4000.

This tendency is reflected in the recent history of warfare in the United States. Citing the five major wars of the past 130 years, DoD compiled casualty data that are compared in Table 5-2.

Table 5-2

Comparison of Death Rates in Principal U.S. Wars

War	# of Deaths (000's)	# Serving (000's)	# Dead per Thousand
Civil War (Union only)	365	2,213	165.0
WWI	117	4,735	24.7
WWII	405	16,113	25.1
Korea	37	5,720	6.5
Vietnam	58	8,744	6.1

Source: Adapted from Department of Defense, *Selected Manpower Statistics*, 1994, p. 112.

The clear trend is a diminishing probability of death during wartime. Of course, the incredibly low number of deaths during Operation Desert Shield/Storm is an extraordinary example of this trend.

2. Less Likely

In *The Evolution of Modern Warfare* (1990, p. 239), historian Christopher Bellamy comments:

Major war, involving total commitment, between developed nations has become such a staggeringly costly and complex process that it is almost impossible to imagine it being used as a political instrument in the future....Most nations no longer accept war as a relatively natural aspect of international relations. The mere fact that earlier this century the United States had a 'War Department', the United Kingdom a 'War Office' and Russia a 'War Ministry', but that they all now have Departments or Ministries of Defence underlies this....It [reflects] a profound reappraisal of the role of armed conflict in international relations.

Bellamy is not the only historian or strategist to declare an end to all-out war. Since the breakup of the Soviet Union, U.S. military strategy has been reevaluated, and the consensus is that,

The United States and other countries most likely will encounter comparative 'little' wars that have specific, relatively limited objectives. The U.S. military calls them 'low-intensity conflicts' or LICs. (Alexander, 1995, p. 45)

The problem for the U.S. is determining which LICs merit our participation. In his *National Security Strategy* (1995, p.

12), President Clinton outlines eight questions to be answered before deciding to employ U.S. forces:

- Can non-military means achieve success?
- Is there a clearly defined, achievable mission?
- What is the environment of risk?
- What is needed to achieve our goals?
- What are the potential human and financial costs?
- Do we have public and Congressional support?
- Do we have timeliness and milestones that will reveal the extent of success or failure?
- Do we have an exit strategy?

Such stringent, self-imposed requirements for committing force are the product of a deep, national sentiment that loathes American casualties. General Schwarzkopf's decision to delay a ground war with Iraq until completion of six weeks of intense aerial bombardment was a product of this same sentiment. Alexander (1995, p. 65) succinctly describes this attitude:

Firepower has been the preferred choice because Americans abhor high casualties and would rather swap dollars for lives. As a result, the U.S. military has gained great public support by substituting shells, bombs, rockets, and bullets for high human losses in battle.

Not only is warfare in general becoming less deadly due to dispersion, but American war in particular is becoming less

deadly because of the deep national sentiment that "abhors" having U.S. casualties.

The point of this entire discussion of the X-factor, second careers, and the evolution of warfare is that over the past 130 years, the very nature of life in the U.S. military has changed dramatically. The changes have all been to the benefit of the service member. The structure of the present retirement system was instituted in the aftermath of our nation's bloodiest war, then reaffirmed immediately after our second costliest war. Now that the nature of military life has been substantially transformed, reexamination of the fairness of the retirement system is certainly justified. A dispassionate and objective examination reveals that the present system is more generous than it needs to be to achieve its purpose, and that consideration of the risks and sacrifices inherent in a career generally fail to account for the tremendous positive changes that have occurred over the past century.

VI. CHANGING THE SYSTEM

Nearly ten years have elapsed since the last change to the military retirement system. Another ten years will elapse before anyone actually retires under that system. Future reformers may well insist on reaping the benefits of their new plan sooner than 20 years from its inception. If that is to be accomplished, the plan must be carefully crafted to accommodate the needs of the Services, the taxpayers, and the retirees. Not only must the plan be sound, it must also be presented in a manner that will encourage acceptance.

A. IDENTIFY THE NEED

The fiscal 1996 Budget Resolution contained language that would change the retirement system for members who entered the service prior to September 1980. The proposal (known as High-1) would calculate retired pay based on the average of the member's highest 12 months' basic pay, rather than on terminal basic pay. The reaction to High-1 was intense, and the proposal later died in Congress. The level of reaction seemed to be out of proportion to the relatively minor proposed change. With that in mind, it may seem as though even more substantial reform would have little chance of becoming law. However, closer examination reveals that the reaction to High-

1 was not so much directed at the change itself, but rather at the abrupt manner in which it was presented to retirees.

High-1 was not the result of any determination that the retirement system needed to be changed. This simple fact accounts for much of the vehement reaction that followed. Indeed, the president of The Retired Officers Association had just recently acknowledged that some compromises would be necessary concerning reductions to retired pay. (Burlage, May 29, 1995, p. 21) The authors of High-1 failed to realize that before such a change can be successfully implemented, the need for change must be clearly established first. The personnel drawdown within DoD from 1992 through 1995 provides an example of the dramatic change that is possible when the need is identified first. Many service members had their careers terminated unexpectedly through Selective Early Retirement Boards (SERBs), strict High-Year Tenure (HYT) rules, and stringent reenlistment qualifications. But the need for major change was made clear far in advance, and the drawdown proceeded smoothly. The victims of SERBs and HYTs would have reacted quite differently had they simply been identified as a source of savings, rather than part of an effort to drastically change the structure of the military.

The lesson from High-1 for future reformers is clear-- identify the need to change the retirement system first, and then seek the best alternative. The history of military

retirement reform reveals that this approach has not been used in the past, resulting in study after study upon which no action was taken.

B. SELL THE NEED

The extensive literature on organizational change conveys a clear message: successful change cannot simply be dictated from above. Kirkpatrick (1985, p. 133) identifies three factors in the process of change:

Empathy, the first key, requires a manager to determine feelings and reactions to a change. Communication, the second key, requires the manager to maintain continuous, complete, and clear communication with all persons affected by the change. The third key, participation, requires a manager to get involvement from those concerned with and affected by the change.

The experience with High-1 suggests that the proponents of reform were not especially concerned with empathy, communication, or participation. All three factors reflect the underlying requirement that a change be perceived as fair to all involved. Future reformers must be sensitive to these perceptions and should realize that the manner in which a change is presented will make an enormous difference in how the proposal is received. This concept was recognized by the Seventh QPMC (1992, GSP-F, p. 11) concerning changes to the compensation system:

When changes are made (positive or negative), adequate explanations should be given to the members as far in advance of the change as possible. Most military members will accept the need even for negative change once the reasons are made clear to them.

C. ACCEPT LIMITATIONS

As mentioned, lack of sensitivity to fairness is an obstacle to successful retirement reform. A less obvious, though equally potent obstacle is that of preoccupation with fairness. Chapter IV demonstrates that fairness is a broad issue with many shades of meaning. People with differing goals are likely to interpret fairness in different ways. Therefore, creating a reform proposal that is perfectly fair to all concerned is unrealistic--fortunately, it is also unnecessary. Several recent changes to retirement policy have been successful despite their apparent unfairness. For example, the Voluntary Separation Incentive (VSI) and Selective Separation Bonus (SSB) were used to induce mid-careerists to separate before becoming retirement-eligible. However, they were offered to a very narrowly defined group, with eligibility being determined by branch of service, grade, occupation, time-in-service, and even promotion zone status. Similarly, 15-year retirement was not offered across-the-board; rather, it was directed at a very specific group of

service members. (It was not entirely voluntary either.) Had the drawdown planners been adamant about maintaining perfect equity, they never could have accomplished their force reduction goals. Although many service members may have wished they had been offered a separation incentive, the feelings were not strong enough to create any sort of backlash.

The Seventh QRMC hints at a preoccupation with perfect fairness. They are critical of the situation that will exist in the year 2006 when two individuals who entered the service only days apart are subject to "dramatically" different retirement plans (High-3 versus REDUX). They state, "Clearly, there seems to be some potential for [retirement] policy to divide the force." (Seventh QRMC, 1992, p. 144) Yet, each individual made a career choice based on a particular retirement plan; and establishing some arbitrary cutoff date is unavoidable. Furthermore, although the individual who entered under REDUX will receive less of an annuity at 20 years, this person will receive more for each year of military service beyond 20. The incentive will exist to stay beyond 20 years, just as planned. How this difference would divide the force is not clear. If future reformers insist on eliminating all such discrepancies, chances for meaningful change are slim at best. Successful retirement reform cannot be immune from any criticism.

VII. SUMMARY AND CONCLUSIONS

Today's federal budget crisis is prompting a reexamination of many entitlement programs. The cost of the military retirement system has risen to \$26.8 billion in 1994, making it a lucrative target for the budget-cutters. This new scrutiny has resurfaced many of the longstanding criticisms of military retirement, foremost of which is the young age at which service members can retire and receive immediate annuities. The fact that the average retiree collects benefits for about 35 years after leaving the military means that the number of retirees will not significantly decline in the near future. Other prominent criticisms of military retirement include the generous level of annual benefits and the cliff-vesting provision at 20 years.

None of the issues raised in the current debate over military retirement are new. Eight major studies of the retirement system were conducted from 1969 to 1984. All of the studies recommended dramatic changes to the system, such as requiring members to make contributions or imposing a 30-year minimum for retirement in non-combat occupations. Common recommendations include ten-year vesting in old-age benefits, a social security offset, and a substantially reduced level of benefits during a retiree's second career phase (prior to age 62).

The Military Retirement Reform Act of 1986 (REDUX) was the collective result of previous studies. However, the changes made by REDUX were relatively mild compared with those recommended in some of the studies. REDUX has been characterized as a "compromise" that did not fundamentally alter the structure of the retirement system.

Any attempt to replace REDUX or modify the rules for current retirees is sure to be assailed on the grounds of fairness. However, the concept of fairness is not restricted to retirees; military non-retirees and U.S. taxpayers must also be considered when discussing the fairness of the system.

Determining the purpose of the retirement system is necessary before deciding whether any particular change is fair. Government studies over the past several decades have mentioned numerous purposes for military retirement, but the primary purpose cited is always force management. The services must be able to retain sufficient numbers of mid-career personnel. Furthermore, adequate incentive must be provided so that service members will separate voluntarily at some point, thus maintaining the "youth and vigor" of the force. The present retirement system certainly provides the incentive to separate shortly after becoming eligible. The criticism is that the lure of retirement is so strong that an implicit contract is established with mid-careerists, allowing too many of them to remain in the service.

The fact that the military is structured as an internal labor market (virtually all recruiting is done at the entry level) allows it to utilize principles of deferred compensation. This economic concept supports the notion that the primary purpose of retired pay is to induce the desired retention behavior from the individual. Consequently, deferred compensation also induces high levels of work effort, by delaying payments until the employee has been observed over a long period of time.

Attempting to determine the fairness of a system naturally leads to comparisons with other, similar systems. The U.S. military retirement system is commonly compared with those of various foreign militaries as well as with private U.S. plans. The consistent conclusion is that U.S. military retirement is more generous than that of most foreign nations and much more generous than most private U.S. plans. Of course, the comparisons do not provide perfect information since many differences exist between the groups. Still, large disparities could be one indication that U.S. military retirement may be overly generous.

Another dimension of the fairness issue is reflected in the concepts of implicit contracts and implicit promises. A common belief among service members is that 20-year cliff-vesting produces an implicit contract between DoD and mid-careerists. The behavior of the Services over the years has

validated this belief. In particular, the separation incentives offered during the force drawdown reveal the strength and constancy of the implicit contract. A much less demonstrable notion is that of implicit promises. Some retirees and their supporters claim that the exact retirement provisions in place at the time of entry into the military cannot be changed for the rest of that person's life. The claim of implicit promises is frequently made with regard to COLAs. However, no historical or logical evidence is available to support the claim of implicit promises.

Military retirement provisions are sometimes justified on the grounds that they are compensation for the many disadvantages inherent in a military career (the X-factor). Yet, the vast majority of service members do not remain until retirement; they do, of course, suffer the same disadvantages as the retirees (albeit for shorter duration). The idea that retired pay is somehow a reward for the rigors endured during a military career has little merit, and was specifically rejected by the First QRM.

Another argument advanced to justify retired pay is that military retirees typically experience a second-career income loss, relative to comparably-aged and educated civilians. This argument overlooks the fact that part of the income loss is voluntary (a decision to work less than full time). Importantly, *total* second-career income (including retired

pay) of military retirees typically exceeds that of civilian counterparts.

Further insight into the fairness of military retirement is provided by a historical perspective. That is, tremendous changes have occurred since the present retirement system was established that have greatly improved service members' quality of life. In short, military life simply is not as "tough" as it used to be. Also, warfare has become less dangerous, owing to modern tactics and the pervading unwillingness of Americans to sustain casualties. Consequently, it is reasonable to suggest that the retirement system should change, in light of the dramatic technological, cultural, and economic changes that have improved military life over the past 130 years.

Nevertheless, changing a system as cherished as military retirement is no easy task. Reformers must first clearly identify the need for change, and then work diligently to convince retirees that the change is fair. Recent attempts to modify retired pay (High-1) failed miserably because reformers focused solely on immediate savings rather than on articulating the need for change and managing the change process.

This entire discussion of military retirement reveals that current benefits (both pre- and post-REDUX) could be reduced while remaining fair to the service member.

Obviously, fairness to the taxpayer dictates that current provisions should change. Nearly any standard of fairness--the needs of the Services, comparisons with others, or the nature of military life--supports modifying the current system. Although retroactive changes must be done carefully, no compelling argument of fairness exists to preclude them.

Finally, service members should take care to avoid the "X-factor trap" when defending retired pay. The sacrifices made during a military career are indeed noble, but compensation for those sacrifices is not achieved through retired pay.

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